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Session 59PD Worldwide Accounting Developments

Track: Financial Reporting/International

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Summary: Accounting methods for insurance contracts vary around the world. In addition, international insurance standards are in the midst of being overhauled. Attendees learn accounting methods in different countries as well as recent developments in international accounting standards for insurance.

MR. S. MICHAEL MCLAUGHLIN: I'll be your moderator and a panelist on today's session. Assisting me are Helmut Engels and Brett McWilliam. Helmut is known to many of you. Helmut has had a long career with Manulife Financial in charge of Canadian financial reporting, Canadian reserving in the U.S. division and NAIC (U.S. Statutory) type reporting, so he's covered the whole gamut. He's familiar with GAAP. His company demutualized in 1999, and he was the leader of development of U.S. GAAP for worldwide operations, so this young man has seen many different reporting bases. He's now with Office of the Superintendent of Financial Institutions (OSFI) and has been there for nine months as director of their actuarial division. Helmut will talk to us this morning primarily about Canadian financial reporting and methods.

We've called this session, "Worldwide Accounting." I'm not sure we'll be able to cover all countries in the world today, but Helmut will talk about Canada and Brett will talk about the U.K.

Brett McWilliam is a fellow of the Institute of Actuaries. Currently on secondment to the United States from XL Reinsurance Company in the U.K., he's managing a big

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Note: The chart(s) referred to in the text can be found at the end of the manuscript.

project for XL Capital related to capital management. Prior to joining XL, Brett was with PricewaterhouseCoopers, working on a range of auditing and consulting activities.

I'm Mike McLaughlin. I'm head of Ernst & Young's Life Actuarial Group in the United States, and we've done auditing, financial reporting, fair-value reporting, mergers and acquisitions (M&A), demutualization—a pretty full range of activity. I will cover emerging developments in international accounting. We'll cover that, including some late-breaking developments.

MR. J. HELMUT ENGELS: We're going to talk about the Canadian regulatory financial reporting environment. First, let me give you some background. In Canada, the Insurance Companies Act passed by the federal parliament governs the operations of insurance companies. There are similar acts for banks and for other trust companies as well. The act specifies what reporting should be done but not exactly how to do it. In Canada, by law, there's only one reporting basis that can be shown in your external statements. So, this one basis must cover, both from a solvency point of view, plus from an income reporting point of view. We don't have an NAIC and GAAP—two sets of statements—in Canada, which gets some pulls and pushes from the actuaries and the accountants.

The act also defines the role and duties of the appointed actuary—that there must be one, that the board or the company must appoint one and what the duties of the actuary are.

We also have the accountants as well. The Canadian Institute of Chartered Accountants (CICA) issues a set of standards called their Handbook, that defines Canadian GAAP. It covers all industries, not just insurance. The U.S. equivalent would be a combination of the FASB, the AICPA, and so on. The handbook contains special rules for insurance companies. The infamous Section 4210 specifies rules for insurance companies. We're allowed to have different sets of rules for asset accounting and for the policyholder liabilities that are set by the appointed actuary, and I'll get into the details of that as well.

The Canadian Institute of Actuaries (CIA), sets standards for how reserves or liabilities are calculated. The standards address life insurance, property and casualty insurance (P&C), and pensions, as well. The CIA also sets the standards for dynamic capital adequacy testing formerly called dynamic solvency testing. A couple of years ago both the name and the emphasis of the standards changed. In Canada, the actuarial liabilities are not audited by the external auditor or by any auditor. There's an agreement in Canada between accountants and actuaries that one profession can use the work of the other profession without checking it or auditing it. This makes certification much simpler.

As for regulators, there's the OSFI, and that's my current employer. It's the one federal regulator, and it regulates insurance companies as well as banks and federal

pension plans. There are offices in Toronto, Montreal, Vancouver and Ottawa. Quebec has a separate regulator for its provincially licensed companies. In any event, in Canada an insurance company reports to only one regulator—either Quebec, if you're a Quebec company, or OSFI if you're a Canadian federally regulated company.

OSFI also has the right to make changes to Canadian GAAP reserves. It's an override power. To my knowledge, it's only been used once over the years. They have threatened to use it many times. It's amazing—you get a lot of action out of professionals if you threaten them. OSFI does some regular examinations of insurance companies. They're not called audits. They don't get into gory detail. They look more at risk management. How's the company working? What kind of assumptions do they use? That type of thing. Typically, they do this every three years. The larger companies will do maybe a third of their blocks every year. OSFI's work is not limited to just Canada. Right now I have a couple of people in Fargo, North Dakota, and I have a couple in London, England. I just came back from Tokyo. Many Canadian companies are fairly multinational, and we'll send people to all of those places to see what they're doing.

The annual Appointed Actuaries Report is a fairly thick report that's required by law. It's the actuary in the company reporting to OSFI all of the assumptions they use, all of the margins they use, and all of the methodologies they use. We're in the process of revising what we want. For larger companies, it's a 300-, 400-page report in the end, so it's quite detailed.

The public annual report, known as the "glossies," must be used in Canadian GAAP. They may put some disclosure in on embedded value, but it's not to be considered part of the actual financial numbers. It would be more in the management discussion and analysis (MDA) sections of it. There is a specific report to OSFI called the OSFI 54. It contains the same financial information as the Canadian financial reporting documents, just a lot more detailed. It gets down to what exact assets you have and what real estate you have, property by property—those types of listings. It just provides more detail, is thicker, and is required once a year.

Three Canadian companies that demutualized listed with the New York Stock Exchange. The reporting they use for that is called multiple jurisdiction disclosure system (MJDS). It allows foreign companies to file their Canadian statements or their local statements, Canadian GAAP statements, but they have to add a very large note with a reconciliation to U.S. GAAP; so in essence, they're doing U.S. GAAP, as well as Canadian, in the same statement. There's also the minimum capital and surplus statutory requirement (MCCSR). It's similar to the NAIC's risk-based capital (RBC), using similar C1, C2 and C3 risk classes, just different factors. Again, this is because the accounting they are going through is different. Then there's the annual dynamic capital adequacy testing, which is required of the actuaries once a year. It's a very private report to the board, and OSFI also gets a copy.

Let me go into some of the differences in asset accounting. Bonds and mortgages are basically treated the same. The asset value in the statements is amortized cost. There are no Financial Accounting Standard (FAS) 115 adjustments just straight amortized cost. Realized gains or losses are amortized over the original remaining duration. So, if you have a bond and you've realized gain and had nine years left to run, you amortize that gain over nine years. Anything that you haven't amortized yet goes into a liability account called a deferred net gain account. Trading, in essence, doesn't affect income or surplus under this mechanism.

Equities are treated somewhat differently. Again, asset value is cost, plus there's an adjustment—the average market approach. If there are realized gains, you take 15 percent of the income in that year and put away the other 85 percent into net deferred gains account. If there were net deferred gains from the previous year, you would take 15 percent of that out again and put it into income. The interesting thing on stocks is that if there are any unrealized gains, you take 50 percent of those as well and bring them into income, so there's a smoothing approach in effect. It also means that realizing gains or losses or actually doing any trading doesn't affect your income or surplus.

Real Estate. Again, the same as equities, except the ten percent amortization.

Other Assets. There's no such thing as a deferred acquisition cost (DAC) asset under Canadian reporting. It's all lumped together in the reserves. It makes it easier because it falls under the actuarial rules. We don't have to worry about the accountants and their rules on separate presentation of the unamortized deferred acquisition cost asset.

Deferred Tax Assets. Again, they exist. The methodology is similar to U.S. GAAP, but because all the numbers are different, the tax number will be different than our U.S. GAAP numbers.

Policyholder Liabilities. The standards are all set by the CIA. The Insurance Companies Act requires reporting in accordance with Canadian GAAP. The accountants define Canadian GAAP, but the liabilities are as defined by generally accepted actuarial principles. The CIA decides on actuarial reserving principles. Making changes to standards is a fairly lengthy process. It goes through due process, through drafts, through exposure drafts, through discussion drafts, and then it finally goes through typically a one- to three-year process. OSFI has complained that it takes too long. A few years ago I was on the CIA council—I was the vice president for life Insurance, in the CIA leadership—and I was the one who was trying to get all these things through all the committees and all the volunteers. I was like "Geez, OSFI, get off our backs; we're doing the best we can." Now, working with OSFI, I have a different attitude: "Come on, can't you get it through faster?" It was an amazing difference.

OSFI has the power to override the accountants or actuaries, no matter what the standards are. OSFI can say, "No, this is what it is." The appointed actuary actually has to sign an opinion, and that shows up in the actual published financial statements. It's a fairly standard opinion. The CIA decides on the wording, and as I said earlier, the liabilities are not part of this. The Joint Policy Statement with the actuary and accountant has been in place for about ten years now, and again, makes life just a lot easier between the two professions.

A new initiative that's coming from the CIA with support from OSFI is the peer review process, starting January 1, 2003. The CIA has come up with proposed standards. The debate has been going back and forth for a few years. It's a question of should it apply to the insurance industry, and should it also apply to the pension guys in the CIA? The pension actuaries are really fighting it, so there's a political issue. What may happen in the end is that the CIA offers standards for peer review if required, and OSFI may put the requirements in place.

The various standards, again, have evolved over time. Pre-'78, it was a net level premium method which, again, is very similar to U.S. GAAP and U.S. NAIC, (who helps define statutory accounting) methodology—just mortality and interest. Between '78 and '92, there was something called the "Canadian method." Again, it was a net level premium, but it had all assumptions in there, not just mortality and interest.

In 1992 a new method called the policy premium method was introduced. This was a prospective valuation method using actual policy premiums, best-estimate assumptions with provisions for adverse deviation (PADs). That was quite a change. It came in as part of an overall package. At the same time, the Insurance Company Act was changed accordingly. Minimum capital requirements were introduced, and actuaries had much more freedom in judgment as to what they put into their valuations.

Between '85 and 2000, many valuation technique papers came out, and they provided very specific, more explanatory, standards on some issues. The first one was on lapse-supported products. Canada has a popular product term to 100—a whole life policy with no cash values. That also required new standards. Ultimately, approximately 13 valuation technique papers were issued. They've all now been folded together into a new methodology called the Canadian Asset Liability Method (CALM). It was mandatory for year-end 2001, and OSFI is currently reviewing those results.

Then, some guidance is provided by a CIA committee, the Committee on Life Insurance Financial Reporting. It comes out around November of each year and usually includes about a half-dozen topics, some late-breaking information as to how you should treat things in valuation. It's not a standard. It's not mandatory. But OSFI looks at it, and if the actuary doesn't follow it, we'd like an explanation of why.

Now, let me talk about the CALM methodology. It's fairly new. Key principles include the going concern concept, as far as the company goes. The idea there is also a spirit and intent to the regulations. You're supposed to look at what the methodology really wants you to do and not just go literally looking at the words. If you have some new type of product, a new type of situation, think about what should have been there as opposed to what the words may exactly say. Assets and liabilities are very interdependent; they're totally linked in this methodology.

Again, it covers all contingencies, anything that could happen. It's all explicit, all prospective only. The actuary should reflect policyholders' reasonable expectations. So, if you drop dividends and your policyholders are assuming they're going to continue getting dividends and you may be thinking interest rates are going down, can you really cut them or not? You must take all of that into account in the valuation. And the accountants are always in there. They would like it to be okay—not too conservative, not too margined—because they're looking at income. So again, the words are "sufficient without being excessive."

CALM is a methodology that applies to all lines of business: traditional, universal life, annuities, property, casualty, it covers them all. It's very generalized, and the methodology is based on blocks of business, not individual policies any more. I'll go through a few steps that should be followed.

First, you select best-estimate assumptions for all of the contingencies, and I've listed them here. Depending on the companies, there may be more. But again, it's best guess, best estimate, whatever you want to call it. Again, they're based on the actuary's judgment; they're not prescribed anywhere, and they have to be based on the policy features—the actual assets, company experience, industry experience—whatever you can use as a best guess or best estimate. And a range of practice is acceptable. You'll find that some companies, just as a matter of principle, want to be more conservative consistently, and some companies are maybe a little less conservative. That's what I think depends on the actuary or the company philosophy. We're more concerned that they're consistent from year to year and also that they're not too close to the line. But a range is acceptable.

Then you project the actual assets and liabilities cash flows. Again, you're working with blocks of liabilities and the assets that are associated with them. Again, using best-estimate assumptions, you project out to the end of the policies and determine whether there is a surplus or deficit at that point. If you have a deficit, throw in a few more assets and reproject it again until at the end of all the policies, you have a zero surplus—the cash flows of the assets and the cash flows of the liabilities match each other exactly going forward—not year by year, but they sort of run out at the same time. The reserve value at that point is whatever the statement value of the assets is. We're taking this block of assets and block of liabilities, and we've projected them out; they now are sufficient to match each other. Whatever the accountants have decided that those assets are to be counted for on the

statements is the value of the liabilities, so you have a real match in the reporting. This is the first step. It's the reserve value without margins.

The next step is to include the provisions for adverse deviations for all of the assumptions (PFAD), except for the interest. Again, you add margins to all of the cash flow assumptions. CALM does give some requirements of ranges—what's not conservative, what's too conservative. But again, you have a range that you can go into and that varies on the actuary's judgment. One thing that is definitely in there is that the margin has to increase the liabilities. Again, for some products high lapses are bad, for some products, like lapse supported products, higher lapses are good, so whatever margin you put in there has to be one that actually goes with the increase in liabilities.

The fourth step is to add in the provisions for adverse deviations for the interest rates. This is done by scenario testing. There are seven prescribed scenarios in the CALM methodology. They're not like the New York scenarios; they're similar but not identical. If that shows sensitivity, if after the actuary has done the seven, then additional scenarios must be run. Then, the final margin is the scenario that produces the highest liability. In the appointed actuary's report that goes to OSFI, we want all of the results from all of these scenarios annually.

The final step is, again, you reproject all the assets and liabilities with the margins on the interest rates, and you make sure that you get zero surplus at the end by adjusting the number of assets that you have. The final number is, again, the reserve equals those assets. That goes onto the financial statements. This is the one that is reported. The reserve number that was determined earlier without the margins, the difference between those two, is the amount of margins, and again, that's something OSFI really wants to see, so we require that. It isn't reported publicly. The only one that is reported publicly is this final one. One interesting thing about the methodology is that you can have negative reserves at the early durations because of the DAC. The deferred acquisition expenses are netted within the reserve, so that may happen in the first few policy years.

Now, where are we going in the future? CALM basically uses deterministic scenarios. We're now probably moving more toward stochastic scenario testing. This last year-end we had new requirements for reserves and capital for separate accounts, "segregated" or seg funds, as they are called in Canada. Seg funds have guarantees—maturity guarantees, death benefit guarantees, which are best measured by stochastic testing of reserves. The process comes up with the total calculated requirement—the total of reserves and capital. Reserves are then set somewhere in the CTE 60 to 80 range, and capital is around the CTE 95, the percentile level referred to as conditional tail expectation. The thinking now is that scenario testing will probably be extended to CALM as an option and evolve that way going forward.

Here is a quick summary on income recognition. Again, going through realized gains and losses on bonds with no effect on income or surplus. Realized or unrealized gains on stocks. Again, amortized 15 percent; no income or surplus effect. You can have a gain or loss at issue under this methodology. In practice, you typically don't encounter gains at issue. Again, income is a function of release from risk, year by year. As the margins are no longer needed, they'll flow into income. Any kind of experience gains and losses aren't amortized at all; they all come into income. If you have a bad mortality year, too bad—it comes into income. If you make assumption changes, and this can really move your income around because it's all prospective, so you're making an assumption change, you bring in the total future value of that assumption change into income in the current year.

If you want more information, refer to the two Web sites, www.actuaries.ca, and OSFI-BSIF.gc.ca. The CIA's Web site has all of the standards—educational material, any background material you might want. OSFI's Web site basically has anything out of OSFI requirements, guidelines and regulations. Everything is in there.

MR. BRETT DONALD MCWILLIAM: I'll speak briefly just to touch on some of the objectives of this session. To try to give you a full rundown of U.K. GAAP in 20 to 25 minutes would be a bit of a tough order, so I've tried to pick out some of the key things. Perhaps at the risk of oversimplification, I'll try to simplify things down to some key ideas that you can take away, general things that apply to U.K. GAAP. I'll particularly try to draw some parallels or contrast with U.S. GAAP. With that in mind, I'll be making a number of references to other materials we go through. So, if you really are interested in reading up some more, there's some additional material for you.

Just in terms of the contents of this session, I'll provide just a brief accounting overview, some of the high-level principles. I'll talk a bit about product classification and also profit emergence. Then, I'll really go into some issues and future developments and probably spend a little bit of time there because quite a lot is going on.

Just to pull out some of the key comparisons against U.S. GAAP, I guess the most fundamental difference to bear in mind is that U.S. GAAP is an accrual method of accounting (Table 1). U.K. GAAP is fundamentally a mark-to-market type of approach. It's more balance sheet driven. It's not income statement driven. I put mark-to-market sorts because once we go on and talk about value accounting, it's not a mark-to-market method of accounting in the same way that fair value accounting is, but it's certainly more directional in that way. The other thing to bear in mind is that it is very much driven by regulatory treatment and very much around the fact that the life business in the U.K. sits within the ring fenced life fund. That is in contrast, I guess, to U.S. GAAP product classification in which insurance contracts can fall between, say, investment contracts or insurance contracts. Practically anything that was written within the life fund is, in fact, a life insurance contract and will follow life insurance accounting.

Table 1

Key Accounting Differences

UK GAAP		US GAAP
Mark-to-market (of sorts)	↔	Accruals
Ring fenced Life Fund	↔	Contract classification
Mid-market asset valuation	↔	FAS115 classification
No contract treated as asset	↔	Cohort assessment
No credit for discontinuance	↔	Persistency included
Discretion allowed	↔	Prescribed by FASB

In terms of the asset valuation, it's fundamentally a mid-market asset valuation. There are some exceptions to that, largely around the treatment in the U.K. of with-profit (dividend-paying) funds. That in itself would be a two-hour presentation, so I won't go into those subtleties here, but I guess that certainly does contrast with the FAS 115, classification of U.S. GAAP where the distinction between asset classifications is just not something that happens on a U.K. basis.

As I say, U.K. GAAP is much more driven by concepts around no contract being treated as an asset and also no credit being given for discontinuance, so that you have to hold a minimum reserve at least equal to the surrender value. That, is in contrast to U.S. GAAP, in which there are concepts of profit assessment or a test of lock-in. Currently, the level at which you'd assess that is fundamentally different. So if you go down to a contract level, you can see differences in the U.K. GAAP, under which you have to treat each individual contract. It can't be loss making, whereas under U.S. GAAP, there's a much higher degree of aggregation. I guess the other fundamental thing to bear in mind is that U.S. GAAP is much more prescriptive. Under U.K. GAAP, a great deal more discretion is allowed to the appointed actuary.

I wanted to just touch on some of the key actuarial reserving methods, which might be of interest. I guess there's no one approach. The net premium valuation is something that's starting to be used, and indeed, initial legislation imposed net premium valuation is used on practically everything. By net premium valuation here, we mean something a lot cruder than a U.S. GAAP net premium calculation.

Implicitly we're valuing on a prudent basis the future liabilities and assessing a premium against those future liabilities so that the difference between the gross and net premium covers expenses and everything else, apart from the true policy liabilities.

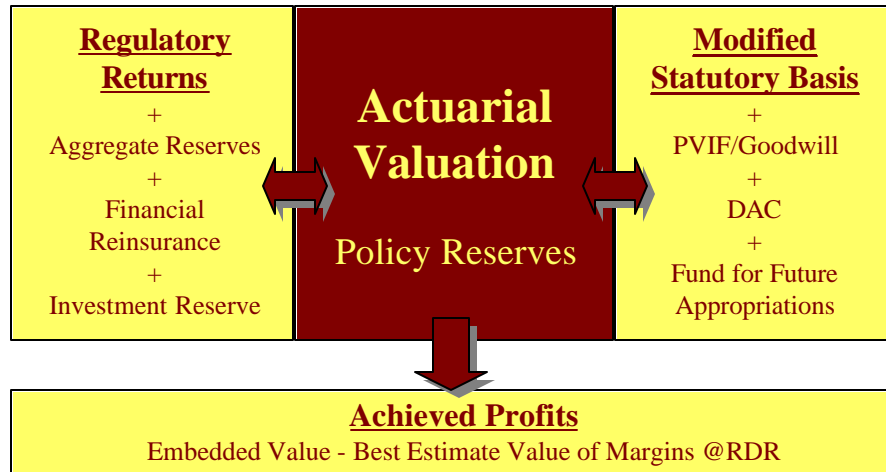
Increasingly, the method has moved toward a gross premium valuation, and based on recent revisions, a gross premium valuation would be encouraged for everything other than with profit business. The discounted cash flow approach really came in as a result of unit linked contracts, or what you would refer to as universal life contracts in the United States, under which a net premium method valuation is fairly meaningless, particularly when you can have cash flows that can change sign throughout the duration of the contract. Therefore, some sort of discounting of the cash flow method is used, eliminating negatives as appropriate. That's not necessarily something that's written in any of the legislation; it's just something that makes perfect sense. So, you have unit-linked contracts that follow a different approach to reserving. Then, I guess there are a bunch of ad hoc methods that are based on the fundamental duties of the appointed actuary to really decide what's most sensible, based on the principles of prudence. Just to give you an example, in the areas of guarantees, the use of stochastic models will be encouraged, looking at say the 70th to 90th percentile as a suitable level at which to hold reserves.

Perhaps the other thing to bear in mind with the reserving methods is that within the U.K. there's a concept of PRE, or policyholder's reasonable expectations, which was originally something that was written into actuarial guidance, but I think has increasingly been used by the regulators as well. Again, this comes into the minimum surrender values. It also means that you have to take regard for the options and guarantees and also that you have to bear in mind what's fair to the policyholder in setting future charges and things like that. I guess, in terms of what you can do, you also have to bear in mind this sort of more intangible concept.

This is quite a busy graphic (Table 2). I guess I've tried to throw all of U.K. GAAP into one slide here, which may take a bit of explaining. I put the actuarial valuation in the center because, fundamentally, U.K. GAAP will be driven by the appointed actuary's valuation on a prudent basis of the policy reserves. For regulatory returns basis, as you go over to the left-hand side of the slide, there would be certain additional reserves that would be held— aggregate reserves for mismatch or crediting risk, those sorts of reserves. Also, there is the offsetting credit for financial reinsurance and that sort of thing within the regulatory returns, although that is changing as well. For completeness, I put in investment reserve—that's something that applies to the with-profit funds. I don't want to talk too much about that now.

Table 2

Types of Accounts



Historically, insurance companies were exempt from the true and fair requirement of accounting. As a result of European Community (EC) directives, U.K. insurance companies were brought into that rule. Therefore, the view is that for statutory accounts, it wouldn't be acceptable just to rely on the regulatory accounts, so there was some sort of ad hoc basis to move to a true and fair basis. Pretty much what happens is that you would take the basic policy reserves. In principle, companies can start removing some of the margins that were built into regulatory reserves, although in practice, most companies don't bother to do that. Fundamentally, they will carry the regulatory reserves over and strip out the worst of the redundancy, so primarily the aggregate reserves wouldn't hold on a true and fair basis. They would also include some allowance for DAC, although again, that depends somewhat on the sort of reserving methods being used. Then there's the concept of funds for future appropriations, which you see in U.K. GAAP accounts and again relates to the with-profit funds.

Fundamentally, what's called U.K. GAAP is the modified statutory basis. Really, it's sort of an ad hoc derivation from the statutory returns, so really I guess the key message is that U.K. GAAP is driven by the statutory basis. Indeed, we'll talk more about this later in terms of some of the changes that are happening with U.K. regulations. But a November 2001 paper from the FSA, (the Financial Services Authority, the main Government regulator of insurance and banking), which was grandly titled "The Future Regulation of Insurance," was really sort of a policy statement of how the FSA intended to go about regulating insurance companies in the future. One of the comments on the subject was, "In some respects, standard accounting practice has been changed by the rules on the preparation of the

regulatory returns and this has resulted in a lack of transparency in the returns." Obviously, their focus is on the left-hand side of this graph, but I guess you could also equally say that it's resulted in a lack of transparency on the right-hand side as well. They go on to say, "Not only is it difficult to assess the true financial condition of insurers, but the formal capital adequacy requirements represent only part of the solvency margin. The remainder is hidden within accounting reserves."

I guess you're thinking this doesn't seem to be a wholly sensible basis on which to measure the profitability of insurance companies, and I guess that's fundamentally why achieved profit methods exist. Fundamentally, what we mean by achieved profits is embedded value. It's not called embedded value for historical reasons because when this all started a number of companies lobbied for different types of things that would be acceptable under achieved profits—one company in particular, obviously, from an accrual basis of accounting. Even they, however, now report under embedded value, which is the common standard.

Implied embedded value—it's not necessarily clear, but the most sensible way to do this is to calculate the present value of the margins in the regulatory reserves. You do this on a best-estimate basis. Perhaps the important comparison with U.S. GAAP is that that's a best estimate basis, updated to the date you do the calculation in light of any changes. You're not locked into any best estimate assumptions; you're basing your assumptions as you go along. So again, embedded value is a more mark-to-market type basis. The most recent guidance from the ABI is that you can use achieved profits as the primary method of reporting under U.K. GAAP. However, I think there's only one company that does this at the moment, and most companies will treat it as supplementary information within their accounts.

There's probably an awful lot more that could be said about achieved profits at this stage, and I don't intend to go into too much more detail now. There is a publication from Ernst & Young in the U.K. that reviews the 2001 achieved profits results for all major UK companies. .

I'm not sure how many people in the United States are actually applying embedded value methods, but I think perhaps one of the key things to bear in mind is that one of the key elements of the embedded value is actually analysis of where the embedded value profit came from. Fundamentally, an embedded value profit method is volatile. In defense of that, one can actually work out where the volatility came from. If you start looking on that basis and strip out which effects were changes in asset values and which were changes in various assumptions, you actually gain a much truer understanding of what is going on with the company.

Regarding product classification, when you compare the U.K. to the United States basis of accounting, everybody talks about profit signatures and they say, "What does it mean to my bottom line?" In fact, one of the key things to bear in mind is that some of the differences actually make a whole lot of difference much higher up

in the income statement. Fundamentally, as I said earlier, all the U.K. contracts will be treated for insurance accounting, whereas under U.S. GAAP, some will be treated for investment accounting (Table 3).

Table 3

Product Classification

UK \ US	FAS 60	FAS 97	FAS 91
Non Profit	Term Assurance	Immediate Annuity	-
With Profit	Endowment Assurance	-	Deferred Annuity
Unit Linked	-	Endowment Assurance	Deferred Annuity

A very good example here would be the with-profits business in the U.K., which is profit deferred in U.S. pension contracts, which would probably not have any significant mortality benefit related to it .As such, under U.S. GAAP, it would be classified under FAS 91. Now, that causes huge problems because in the U.K. there are no separate account contracts. There is no policyholder's account for these contracts, so you fundamentally have to invent one. But it also means that when you look at the revenue account, you get some completely different treatments. On the U.K. basis, you thought you had large revenue, such as premiums and the investment return. Instead, on a U.K. GAAP basis, your turnover (revenue) is much lower. Similarly, if you were to look at the cost side, you'd see a mirror on the other side. I guess even before you try to work out what difference it makes to your bottom-line profit, it's fundamentally a completely different way of looking at your business.

Relating to profit signatures, I will give a simple example. Consider a term insurance policy—I'll just show you the basic assumptions, and these are very simplistic assumptions. You have a premium that runs off, actually unrealistically, fairly linearly with lapsation. You have some expenses—some very high up-front expenses and some lower maintenance expenses. You have your claims. increase as people get older. Over the duration of the contract, claims will ramp up and so you have, which hopefully isn't too contentious, a net cash-flow position in which

you make profits in year one, some profits which you have to feed into reserves, and then perhaps some net negative cash flows toward the end of the contract.

What does that mean for the sort of profit you show under these contracts? Well, that can't be too contentious. U.S. GAAP, something nice and smooth in due proportion to the premiums. I think for the U.S. basis, the profit signature is not so sensitive to the assumptions you can put in because fundamentally you're still going to amortize your profit in line with the premiums. Under the U.K. basis, there's no concept for amortizing, or smoothing profit throughout the duration of the contract. Therefore, the profit signature is going to be incredibly sensitive to the assumptions you put in, or fundamentally how profitable the contract is that goes in. This is an example only, other policies could be completely different, so I don't mean for you to come away from this with some view that this is how U.K. profit signatures look compared to U.S. GAAP, but hopefully as we go through this, it will perhaps illustrate and bring out some of the main points.

On a U.K. regulatory basis, I guess we'll see a big loss up front. There is typically no significant deferral of initial expenses. You embed some in. You embed loads of margins into your reserves, which will release over the duration of the contract. If you go to the U.K. GAAP or what I call the modified statutory basis, you're probably going to DAC some of that initial commission; that's one of the big adjustments you're going to make. The extent to which you do that is under question, so it may still be negative up-front, but I'll show you that you have actually mitigated all the DAC up-front. Still, fundamentally you're embedding margins in the reserves that are going to emerge not necessarily in line with the premiums. Perhaps in line with the way I've allowed the U.K. regulatory margins to emerge, they'll increase over the duration of the contract.

If we then look at the embedded value profit basis, the big question is, how profitable is this contract? Under the embedded value, you're going to build a margin in the discount rate. Now, I guess the question is, against that sort of profit criteria, how profitable are you now? If you've priced this product on the basis of embedded value return on capital, then you're not going to get any profit up front because fundamentally it's just going to emerge as the discount rate unwinds. But I guess being optimistic with selling profitable business, you could fundamentally bring a lot of that profit up front from the contract and then, assuming this is a very profitable contract, you'll have a smaller emergence of profit later on. Fundamentally, the present value of all these numbers should be the same because all we're doing with reserves is moving the profits through time—we're not fundamentally changing the economics of the contract.

I guess that is a whistle stop of the basic ideas around U.K. GAAP, but I'm now going to move on to talk about some of the current issues and future developments. One major topic is the solvency problems of Equitable of the UK. I'm not sure how aware people will be of exactly what this is about. Fundamentally this is about guaranteed annuity options (GAOs) on with-profit business in the U.K.,

where Equitable had assumed that it would be able to change bonus philosophy on the contract that had the GAOs in order to adjust people's terminal bonus such that they would get back into the below-net cost. This went through the courts, right up to the House of Lords, which is the equivalent to the U.S. Supreme Court. The House of Lords, in a slightly unusual ruling because they ruled more generically than on the specific case, basically said, "You can't do that. You made a promise to the policyholders that you're going to give them this option; it has value; you can't just change your bonus philosophy in order to get out of it." What that meant was, on a going concern basis, Equitable was "insolvent." They're not technically insolvent, because under a statutory basis they have enough money to meet their guaranteed liabilities. But they don't have enough money to meet policyholders' reasonable expectations of future bonuses.

One of the interesting things about this is, this is not an Enron-type event where nobody saw this coming; this is something that people saw for years and years. It's just that they thought it would all work itself out in the end. A lot of questions have been asked as well. Somebody must be blamed for this. Was it the appointed actuary? Was it the regulator? Was it the auditor? Was it the management? Perhaps the answer is, it was a bit of all of them, actually. One of the other fundamental questions that's asked involves the transparency of U.K. with-profit business. I think over the coming years we'll see a dramatic change in the way in which that business is written, even to the extent that a lot of companies have actually withdrawn from writing traditional with-profit business and are moving toward a unitized with-profit approach, which is not totally transparent but is certainly a lot more transparent.

One of the other key things going on involves stakeholder pensions. This is something brought in by the U.K. government to encourage increased pension saving by generally the more lowly paid people in order to move the burden away from the U.K. states. I guess the key thing is that the maximum charge you can apply on those policies is a one percent management fee; no other charges may be applied. That's caused a great deal of difficulty, because traditionally companies have not run to those sorts of management charges. I guess you combine that with the new regulatory approach, and you can see the things coming together. Again, quoting from the FSA, their comment is, "An efficient insurance services set to an efficient regulatory regime will help the achievement of a number of government objectives—for example, encouraging individuals to take more responsibility for their long-term financial needs and making financial services available to all who need them."

Or put differently, Tony Blair is not very happy about things. Even further back in time, if you look at pensions that are selling, I think the current cost is around \$20 billion to the U.K. life insurance industry. Those sorts of events, coupled with the government's desire to encourage people to take out more pension contracts, is not really consistent. So you bring the two together with a new regulator coming in who has responsibility for all financial services and also has increased power, and you

can see they have a government mandate to really change things and make sure this sort of things doesn't happen in the future. I think they've certainly taken that onboard, and they're going to be much more proactive in the way in which they regulate the insurance industry.

The other point I'll just raise here is that increasingly, large U.K. insurance companies also prepare U.S. GAAP accounts. A good number of the top companies are SEC-listed now or are thinking about doing so or at least want it in their back pocket so that if they want to raise capital in the U.S. markets, then they're able to use shares for acquisitions, that sort of thing. Increasingly what you're seeing in the very largest of the insurance companies is that U.K. GAAP is not really their key focus. Even now, they're even thinking in terms of U.S. GAAP. With International Accounting Standards on its way, and the general marginal value of the U.K. GAAP, those aren't really things that people have focused on.

What's happening now? As a result of Equitable and the new Financial Services Authority coming into play, it was accepted that one of the things that was wrong with the existing system was that appointed actuaries were basically God. Even within the actuarial guidance, it's forbidden to question the judgment of the appointed actuary. Personally, I don't think that would have made any difference in this situation at all, but it's certainly one thing that raised interest. So it was fairly clear that some sort of external review of the work of appointed actuaries was going to be appropriate. In fact, things have moved further since then..

There's a new FSA missive dated May, 2002, entitled "The Future Role of Actuaries in the Governance of Life Insurers," in which they say: "The responsibilities which the government currently places on the appointed actuary may lead directors and senior managers to place too much reliance on the views of the appointed actuary rather than reaching their own views. For example, in the regulatory returns, the liabilities are currently signed off by the appointed actuary. The directors do not sign off the reserves, nor are they audited. The valuation of liabilities is of fundamental importance to the financial condition of life insurers. We consider that directors ought to satisfy themselves of these matters and that they should be brought within the scope of the audit."

Said differently, the appointed actuary regime is on its way out. It may be replaced by something that fundamentally has some of the principles that are currently within the appointed actuary system. But fundamentally, there's much more focus on risk management, there's much more focus on corporate government. So, the responsibilities that the appointed actuary currently has will be pushed up to the board, and an actuarial function will have much more of an advisory role.

The integrated Prudential Source Book is fundamentally the new regulations that will come in. They're targeted for 2004. These are actually very much tied in with the international accounting standards. We again have to look at a risk-based approach to management. They're also, remember, not only a regulator for the

insurance industry, they're also the regulator for banks and for managers and they're saying, well, we've actually had some experience managing the risks in banks and we quite like the way that works. That sort of thing is coming your way. We also fundamentally like the sort of fair value approach to things, so they're looking at the regulatory regime coming in line with the fair value approach to accounting. Now, with some caveats, the regulatory regimes will not necessarily exactly mirror the international accounting standards, but rather they would be based on the fair value approach with some adjustments.

The other key development that's on the way is the Basel Capital Accord that is also going to influence this. I guess the key thing here is that those effects don't necessarily all coincide, so the problem for U.K. insurers is knowing exactly where they're going to be in the meantime. But I guess that's a very good point to turn over to Mike, who is going to talk to us about international accounting standards, which really is the way that the U.K. accounting standards are going.

MR. S. MICHAEL MC LAUGHLIN: Thanks, Brett. I'll talk about international accounting standards, what they are, and why should you care. Time permitting at the end, we'll talk about related topics, including the current direction that FASB is taking in the United States, and embedded value and a little about how that relates to IAS.

First, let me give some background on international accounting standards. There was an international accounting committee formed in 1973 with a mission of developing a set of high-quality, understandable, enforceable, global accounting standards. Even as far back as 1973, there were different standards in the U.S., Canada, U.K., continental Europe and elsewhere. The idea was lofty, namely to harmonize accounting standards worldwide. Here we are 28 to 29 years later still working at it, although perhaps we are closer than ever before. The mission statement was the commitment to develop a single set of standards globally with transparency, comparable information, in general purpose financial statements.

That committee became the IAS board. International accounting is mandated by the European Commission of Public Companies with effect by 2005. The European Commission is able to make this requirement and affect companies directly. They don't need to go through any further due process, such as going through regulators in individual countries, so the requirement to comply with international accounting standards for European companies is already in place. A few companies—not life insurance companies—are already in compliance with IAS, and that train will come through the station here in the United States, too. We'll talk a bit more about the impact on insurance companies, of course. The mandate in Europe will probably spread to other countries. It is also likely to apply to nonpublic, nonlisted companies in continental Europe.

Chart 1 shows the structure of the International Accounting Standards Board. It has some parallels with FASB. There's a nominating committee, a board of trustees and

full-time board members. The staff is knowledgeable and experienced. One member of staff is known to some of us here in the United States. Wayne Upton was senior project manager at FASB and followed fair value development for many years, including getting a deeper understanding of embedded value, and direct and indirect methods. He worked closely with the Academy and Society of Actuaries over the years. He is on the staff of the IASB. There is an Insurance Advisory Committee; there is a Standards Advisory Council, which is independent; and there's a Standards Implementation Committee as well.

It's a fairly elaborate structure but certainly has full weight of governance in Europe. Among the priority projects are insurance, performance reporting (and how that should be done), and improvements to IAS-39, which we'll talk about just a bit more in a moment. Why is this a priority? The industry was historically mutual. Financial reporting was somewhat fragmented, dictated by national regulators, and was typically solvency-driven as opposed to measuring earnings year-by-year. The insurance industry is now demutualized, by and large. It's looking to raise capital across borders. There is greater integration within Europe. There is greater integration globally. How would you manage and regulate companies from other countries with very different accounting systems? It was just becoming more and more of a problem to regulate, to raise capital. More and more there's convergence—not just geographically, but between insurance and banking and other financial institutions. It just makes all kinds of sense to have common regulation and measurement of these different converging industries in Europe and globally.

The International Accounting Standards Committee produced a large issue statement that was published in May, 1999. The committee received a large number of responses, but it was already clearly moving in the direction of fair value reporting. There is, perhaps, no one perfect definition of fair value reporting, but this issue statement was a very thoughtful document. It paralleled in many instances some of the thinking that the actuaries have done and that the FASB had done. Many responses to that provided the impetus to move forward with what is now the draft statement of principles (DSOP). Many international financial reporting standards have been issued; think of them as FASB statements, if you will. They apply to many different fundamental principles, many different specific types of transactions.

Specifically, I'll just single out IAS-39. It applies to financial instruments. These are financial assets and liabilities, specifically excluding insurance, although it includes some contracts that we have, in the past, thought of as insurance contracts. To the extent there is no insurance risk, they would be covered by IAS-39. There is no present standard for insurance. IAS-39 is similar to FAS-115 in the requirement of classifying assets between trading, held to maturity, and available for sale, with similar measurement treatment as under FAS-115. Some of us are not particularly proud of FAS 115 as a way to go, and it would be particularly bad if we retained

that FAS 115-type of disconnected approach to valuing assets, but then moved to fair value of liabilities. You'd still have an imbalance between assets and liabilities.

The good news is that the IASB clearly understands that this approach is not a permanent solution and already is in the process of amending IAS-39. The direction that they're presently taking is to permit all assets and liabilities to be held at market value. There's still a slight disconnect with the DSOP but at least it certainly is a step in the right direction. It is not a requirement, however, for fair value. IAS-39 also requires classification of liabilities, which could become important if certain contracts that are not insurance contracts fall under IAS-39. So there's a fair value requirement with changes flowing through income in some cases or an amortized book value in other cases and, of course, different answers, depending on where you come down there. You all know how difficult it is to come up with final answers for insurance—how to do a reserve.

It was interesting to me that Helmut talked about four or five different methods that have been used in Canada over the years. Brett talked about three or four different methods used in the U.K. over the years. In the United States, we aren't any better because we have four or five different FASB statements, depending on how you count them, that you've got to work through to figure out how to report reserves for insurance business in the United States. So, it hasn't been easy over the years to specify reserves, even with as many smart actuaries, accountants and professors working on this as we have had. The DSOP, which is based on the issues paper put together by the steering committee and is being reviewed by the IASB, is in process. It will migrate toward an exposure draft and then ultimately an international financial reporting standard for insurance contracts, not insurance companies. Hopefully, it will bring greater consistency in insurance reserving.

The timetable targeted mid- to late-2002; may or may not be met. Already there's a bit of talk that perhaps it could slip to early 2003. If so, it may not be possible to have an insurance standard effective as of January 1, 2005, which is the effective date for all the other international accounting standards in Europe. There could quite possibly be a delay in implementation of an insurance standard.

A tremendous amount of work has been done on the DSOP. Our firm and others have been involved with this work. It's not a final document until it's approved and then issued as an exposure draft, but I'll discuss some of the main provisions. It'll apply to insurance contracts, not insurance companies. There needs to be insurance risk present in the contract for it to be considered insurance, so a GIC on certain types of deferred annuities would come under IAS-39 the way things look right now. It does apply to insurance, not life insurance, and so the property and casualty companies are also affected by this. It calls for the same general approach to all contracts—life and P&C, including discounted present value of future cash flows, which is somewhat of an anathema to many of our colleagues on the property and casualty side, but nonetheless a requirement. But the approach will be at present, the way it's described, either fair value or entity specific. As a practical

matter, there may not be a huge difference, but it is important to understand the difference.

Entity specific means the value of this set of insurance liabilities, the way the entity holding the obligation views them. So the entity would look at its expected liability cash flows, and it would also have a view that it would be certain to make those liability cash-flow payments. Fair value is conceptually different because it looks at all the liability cash flows with the view of a market participant. So the view would not necessarily be that of the company itself. This gets a little fuzzy. The company will know how its book of business is likely to behave, but the view to be taken of those cash flows is that of a market participant, as if there are many players who would form a consensus opinion as to what those cash flows are worth. In addition, those cash flows are not certain to be paid because the entity holding those obligations has some level of risk as indicated by its credit rating. So if it's the highest-rated corporation possible, nonetheless, there may be only a 99.95 percent probability of paying those liability cash flows. Poorer credit ratings mean an even lower probability. That type of credit risk is to be reflected in fair value. How big of a difference that makes in practice is not certain at this time.

The process is to determine the expected present value over all possible outcomes. To actuaries, this is fairly familiar territory. We will look at many stochastic scenarios. We would discount those cash flows at a risk-free discount rate. This is not the only approach, but is the preferred approach. Risk in those liability cash flows should not be swept into some kind of discount rate margin. Instead the discounting is at a risk-free rate, whatever that is, and risk and uncertainty are to be reflected in the cash flows. The DSOP is not very clear how this should be done, but clearly some kind of risk margin should be considered in looking at future cash flows. In addition, it's very clear that any guarantees or options in those future cash flows should be valued. This may not seem like rocket science to all of us here, but there are many places, for example, even within the GAAP literature, where a non-guaranteed benefit is not only not required to be valued, but you're prohibited from assigning a value to that benefit because it's uncertain, it's not guaranteed. Some of the guarantees in variable annuity contracts come to mind.

Brett talked about four different methods for U.K. reserving for a term product. With three of the four, there was no break-even at issue. So with U.S. GAAP for most contracts, you target break-even at issue, although it would be possible to have a loss certainly, but not a profit at issue. There is no such constraint with embedded value. Similarly with DSOP methodology, either for entity-specific or fair value approach, initial reserving might very well result in some profit or loss. There's debate as to how big that is likely to be, but as an example, consider a contract that has mainly interest spread to the extent that you earn eight percent on assets and pay seven percent on liabilities. To the extent you value those liabilities at a risk-free rate, all the profit that you're going to get from spread is not yet embedded—not yet present valued. At issue, the value of liabilities will exceed the value of the assets. There will be a loss at issue for most contracts that are

primary spread-driven. Many contracts that are primarily insurance risk-driven such as term life will have profit at issue, because the liability calculation will include the present value of the profits to the extent premiums overall exceed benefits and expenses. There are some business implications to that. Will the industry or will a particular company within the industry prefer to have one type of policy versus another? Most likely.

Other issues. Because this is a fair value or perhaps proxy of market value, you will see volatility—volatility in equity and volatility in earnings. It's going to become complicated to analyze that. If you were in company management, you would want to identify the extent to which earnings of the past year, for example, arose purely due to changes in the interest rate environment. It would be some kind of reflection of how well your assets and liabilities were matched, but you would most likely want to separate that and then have some separate measure of whatever operating income is. Analysis of results will be complicated. What, for example, is your expected mortality? Or what's your expected interest when we have 1,000 scenarios and actual experience falls somewhere in that range—is there a variance? So, what is "expected?" There are some issues there.

We talked already about consistency between financial instruments and insurance contracts. At present there are some disconnects that are not fully resolved by the amendments to IAS-39. Corresponding assets and liabilities should all be on the same basis. There would need to be further changes in the DSOP to completely eliminate some of the disconnects that exist.

Performance-linked contracts. This term is not precise, but it probably means policies such as participating ("with profits") and variable products. But if you read the definition closely, you could maybe include universal life in the performance-linked category. It's a bit unclear, but to the extent that you have a performance-linked contract, there probably would be the requirement for a liability component for future policyholders' reasonable expectations.

Cost of capital is not explicitly required or even mentioned, but to those of us who work with embedded value or actuarial appraisals, that's a significant adjustment to value. So, how could you possibly build a whole brand new financial reporting mechanism and not actually mention cost of capital explicitly? It's probably buried in there somewhere in market value of margins. As an aside, my company gave a seminar on fair value and Peter Clark (IAS) was there. At the cocktail hour, almost all the discussion concerned credit risk, whether to reflect it and how large it might be. But a much bigger issue is cost of capital; I asked Peter where we fit this in. He said, "We're going to get to that real soon now." I'm not criticizing Peter. He's a super guy, but I'm just pointing out that there are still some significant ambiguities or loopholes or issues that have not been fully addressed.

I want to make a couple of minor additional points. We already talked about separately reporting "mismatch income." To banks this is familiar territory—this is

the income that arose solely because interest rates changed and your assets and liabilities were different.

But also under IAS financial reporting there is no DAC. Actuaries probably won't shed too many tears about losing DAC. Presenting DAC separately under U.S. GAAP is considered somewhat of an artificial unbundling of the effect of acquisition costs, but it's a significant issue in IAS when reporting net reserves. There was a hurdle, I think, that's been crossed now, where there was a view that reserves should not fall below surrender value. To the extent that you have no DAC, your reserve is net of the effective initial acquisition cost. So, your reserve could be less than account value and less than surrender value. As Brett pointed out, your reserve could appropriately be negative at some stages in the life of the contract.

Challenges include massive retooling of existing models. Present valuation systems built in this country, value policy by policy, and that's such hard work that it's very uncommon to see stochastic reserving. That will change. Option pricing models will be needed, so you're going to have to figure out whether to go straight at them or build modeling into your valuation system. Actual versus expected analysis will be more difficult. Disclosure requirements are quite complex, following along the lines of embedded value and British-style regulation, to where you don't simply report one single number for a reserve, but you show present value of future benefits separate from present value of future premiums, where the contract has future premiums. So, there's a good bit of additional breakdown of information that needs to be disclosed. Other disclosures may include release of margins, unwinding of the discount rate and assumption changes. These concepts are similar to embedded value.

Probably the biggest implementation problem—we hear of this in Europe—is where are we going to find enough actuaries to get this job done? And they're not kidding. Meantime, what are we doing in the Society and elsewhere? We're including a few more exams in the syllabus, so we can have even fewer actuaries than we already do. This is virtually an emergency demanding lots and lots more actuarial talent.

Some business implications—we've touched on this before. Earnings will be more volatile. Companies will change their investment strategy probably, to more active management of duration matching. Financial results will be sensitive to new business. There will be incentives to sell different kinds of business, depending on initial profitability. The exposure draft likely will be completed in early 2003. Field visits are being conducted now, finally, in the United States. Field tests will happen at some point in time, I believe, and yet until recently, there wasn't much talk about doing field testing. It seems to me you ought to go through a year or a couple of years of doing fair value in all companies, or at least some companies, before throwing out the entire old financial reporting mechanism and replacing it with a completely new set of rules.

The effective date, January 1, 2005 will occur, but there's now some discussion about transition arrangements for insurance. It's quite possible that there will be some transition arrangement, during which companies report insurance contracts on local GAAP or possibly U.S. GAAP until perhaps 2007. This is an opinion. This is not anything that's been disclosed or stated by the IASB, but that's under discussion. I think what we will see is international accounting standards spread around the world, with a possible exception of the United States.

As for a disclosure approach, a group of, I think, 16 European companies wrote Sir David Tweedie, head of the IASB and said, I'm paraphrasing a little, "For heaven's sakes, let's do this on a disclosure basis instead of a measurement basis, at least for awhile. Let's see how this thing works."

FASB in the U.S. is committed to fair value. They believe that all financial instruments should be carried at fair value. I love this quote: "When the conceptual and measurement issues are resolved." That's a pretty big caveat, but they are working in that direction and have been doing so for years. FASB issued Concept Statement No. 7 in 1999. That gives the guiding principles essentially under which FASB statements will be issued. The Preliminary Views statement was more specific, and it dealt with financial instruments, including insurance to be reported at fair value. It had some pretty key specifics here: The time value of money is to be reflected. Risk is to be reflected, as is cost of uncertainty and credit standing of the entity. Fair value is exit value—it should be a best estimate. Future cash flow should be discounted, but not at the asset rate. Instead, the risk-free rate is one of the preferred methods to be used. Models are okay to be used.

Some of these statements are fairly weighty ones. It's being admitted now for the first time that actuarial models will be necessary to produce financial statements. This is a far cry down from the hierarchy of determining market values from active secondary markets, analogy accounting or accounting with respect to instruments with the same set of cash flows, appraisals by experts, and now at last, actuarial models. So this again emphasizes the importance of the kind of work that we do. Gains and losses will flow through earnings, maybe at the very point of issue and beyond.

We're getting down to some specifics now. Commissions are not part of fair value; they're expensed when incurred. If there's a bid-ask spread, we take the midpoint. Creditworthiness and credit risk premium should be reflected. There will be a new statement coming out on fair value measurement and disclosure. So, in other words, the Preliminary Views statement will become an exposure draft on a new standard.

Very briefly, I'll talk about embedded value. Brett mentioned and made some comments about that. It's fairly common in U.K., continental Europe, and Canada. It's publicly disclosed in some places. In some cases, it's generally just supplementary information, but in Canada the equity analysts refer to it a lot. They

think it's got great status as a "second opinion" on the value of an organization, and it provides some insights that perhaps the existing or the previous Canadian methods did not.

One reason it's kind of important to understand embedded value (EV) is that some of the disclosures under IAS will be generally similar to those used for EV. In fact, there was talk at one point - that embedded value could be one of the disclosures under IAS. Embedded value shows a beginning value and a roll forward to an ending value. As many of you know, it's very similar to an actuarial appraisal, but it doesn't include the component of profit that would arise from business to be issued in the future.

In the U.K. and Europe, when you look at market cap of companies, it also has embedded value. There's a big disconnect and there's a multiple of—Brett will tell me if I'm wrong—from 1.5 to two times the embedded value to get to a market cap, because of the omission of new business. EV is very important, nonetheless, and of increasing interest in the United States for some different purposes, such as incentive compensation. Although EV is not governed by a uniform global set of standards, the actuarial profession over the years has come to a pretty good common understanding of what embedded value is. For that reason, it's quite important to multinational or global companies. We see many global companies that use EV as a better way of having uniform reporting back to the head office. It's a proxy for fair value. It's sort of a good dress rehearsal, in my opinion, for fair value. You get a sense of volatility of earnings, volatility of equity. There are all kinds of good uses for embedded value, including testing for goodwill impairment under FAS-142.

Our U.K. colleagues believe quite strongly that companies that do embedded value will have an easier time switching to fair value than those that don't. At some future date U.S. companies have to convert to fair value, but if they've never done EV it will be a bigger conversion effort than if you're already doing EV. There's one kind of "if" to all that, which is that EV is typically done deterministically, not stochastically. There's probably no fundamental reason why you couldn't do it stochastically. In fact, I would say you probably should use a risk-free rate, reflect riskiness of cash flows in those cash flows, and report on an EV basis as if one day you will be doing fair value reporting.

That concludes my remarks. Let's briefly open it up for questions.

MS. MARSHA WALLACE: This is for you, Mike. You said the credit standing of the holder was reflected per FASB. Shouldn't that be of the issuer? I thought it was the issuer.

MR. MCLAUGHLIN: If we're talking about liabilities, we would reflect it as the credit standing of the company that holds the liability has to meet the liability.

MS. WALLACE: Okay, then the second question is on some of the new developments. You said the commissions are not included in the fair value, but are expensed. Is that just up-front commissions or is it recurring commissions?

MR. MCLAUGHLIN: Up-front commissions.

MS. WALLACE: And then the last one is on the credit risk. You said something about credit risk being recognized as part of the new development, and I was wondering, where is that manifested in new developments? Where is that coming from? Is that in the DSOP?

MR. MC LAUGHLIN: It's in the DSOP, but at the time I made that comment, I was talking about FASB. It's included in the Preliminary Views statement. They've reaffirmed that recently also.

Chart 1

